THE SURPLUS IN COMMERCIAL BANKING

The surplus is generally regarded as one of the strongest "talking points" in bank advertising. It is not uncommon to find it printed on a balance sheet in red or heavy black type, in order to direct specific attention to this presumably significant item. The comments accompanying the bank statement, moreover, usually lay especial emphasis upon the accumulation of a large "surplus fund," pointing out that this is an evidence of the growth of the bank, and also of its great strength and safety. The current phrase is that "the surplus fund has been accumulated for the added protection of depositors." Upon reading this statement the prospective but timid depositor may be expected to exclaim: "My money would certainly be safe in a bank with such a great surplus fund." To the rank and file of laymen the surplus undoubtedly appears to be a sort of cash reserve which is to be used for the protection of the bank's customers in the event of unusual losses.

The function of the surplus as viewed by the framers of our national banking law and by writers on banking theory may be indicated by the following quotations:

The national bank act provides that each national banking association

shall, before the declaration of a dividend, carry one-tenth part of its net profits of the preceding half year to its surplus fund until the same shall amount to 20 per cent of its capital stock.

Pratt's Digest advises that

a surplus fund should be created from the earnings that will be a protection to the capital and to creditors in the trying times that sooner or later overtake all banking institutions. There are few items, if any, that look better upon a balance sheet than a large surplus, and none so well calculated to secure for it public confidence.[1]

Scott[2] writes that "surplus funds may be accumulated as a means of meeting temporary losses without infringing upon the

[1] *Pratt's Digest of National Banking Laws* (1908), p. 243.

[2] Scott, *Money and Banking* (revised ed.), p. 132.

other resources of the bank"; while White contents himself with saying that the surplus is "set aside as a permanent addition to the guarantee fund."[1]

Fiske states that "sometimes a bank starts with a surplus contributed by the shareholders in proportion to their quota of shares. This strengthens the position of the bank and gives it resource against early loss without entrenching upon capital."[2]

H. Parker Willis, secretary of the Federal Reserve Board, makes a more extended statement of the service of the surplus than any of the others. He says:

> The surplus acts as a buffer in the event of serious loss or the failure of certain assets to materialize as they had been expected. In the case of a $100,000 bank with $20,000 surplus, if a dishonest cashier disappears with $15,000 in cash, the bank is still left with its capital intact and $5,000 of additional funds. Had the bank possessed no surplus the capital would have been impaired to the extent of $15,000 and the result would have been a necessary reorganization for the purpose of either reducing the face value of its capital stock to an amount corresponding to the reduced net assets (in this case $85,000) or else a call upon the stockholders to make good $15,000 in pro rata contributions in order to restore the capital to its face amount.[3]

The purpose of this paper is to challenge not merely the popular conception of the significance of the bank surplus, but also the theory of the surplus account as incorporated in the banking legislation of this and other countries and as expounded in the standard treatises on banking. An attempt will be made to show that the creation of a surplus does not, in fact, necessarily strengthen the position of the depositors; indeed, we shall attempt to show that inasmuch as the principle of double liability of shareholders has not been made applicable to surplus, the creation of a surplus may even lessen the ultimate security of the depositors.

I

The popular conception of the bank surplus merits a moment's consideration here, for it is not confined merely to the layman; it is found in the most unexpected financial quarters. As already

[1] White, *Money and Banking* (3d ed.), p. 214.

[2] Fiske, *The Modern Bank*, p. 31.

[3] Willis, *American Banking*, pp. 149–50.

indicated, the "surplus fund" is regarded, so far as the general public is concerned, as a sort of cash reserve. That is to say, the surplus, which is a statement on the liability side of the balance sheet of the owner's interest in the business arising from accumulated profits, is conceived of as a resource in the form of actual cash; when, in fact, it is represented on the resources side of the balance sheet by assets in general rather than by cash specifically. In a similar way, owing to the ignorance of accounting principles, which obtains even in financial circles, capital and deposits are commonly thought of as cash; whereas they are of course statements of claims against the general resources of the business by shareholders and creditors respectively. It is this that explains the current practice in bank advertising of measuring the strength of a bank by its liabilities rather than by its assets. I refer to the almost universal custom of emphasizing *deposits* (debts) as evidence of the strength of the bank.

We have said that this confusion of mind is not confined to the layman. Evidence of this may be gleaned from a perusal of the foregoing quotations. There appears to be here either much careless thinking or else extremely careless writing. Doubtless not all of these writers are thinking of the surplus as a *cash reserve*, but the choice of words is generally such as to leave the student with an entirely erroneous conception of the function of a surplus. In my experience the lesson most commonly drawn by students from such quotations is that the surplus is a sort of extra reserve fund.

The two following examples, which have recently come to the writer's attention, will suffice to reveal the views of those high in financial circles as to the significance of both deposits and surplus. An editorial in the London *Statist*, in commenting upon the great increase of deposits in the banks of England during the war, refers to this condition as an enormous increase in "cash resources." The writer's plain assumption was that these deposit accounts largely represented actual cash left with the banks. Lord Cunliffe, governor of the Bank of England, on the occasion of his recent visit to this country in the interests of international finance, reported that the Chicago banks were in excellent condition to stand the shock of a war "because of their large reserve and surplus funds." This use

of the term would seem to imply that the surplus is a sort of supplementary cash reserve, or a fund so invested as to place the banks in a position to secure on short notice additional cash resources.

In order to analyze these various conceptions of the function of the bank surplus it will be necessary to distinguish between a bank as a day-to-day going concern and a bank in liquidation. A commercial bank has a double problem of solvency: it has to maintain, first, *immediate* or *day-to-day* solvency; and, second, *ultimate* or *liquidation* solvency. The law holds that a bank becomes (immediately) insolvent when it is unable to meet current obligations on demand owing to a depletion of the cash reserve. It might thus be temporarily insolvent even though its assets were ample to meet, ultimately, all obligations.

Now whether the creation of a surplus strengthens the ability of a bank to maintain *immediate* solvency will revolve about two considerations: First, does the setting aside of a surplus increase the ratio of cash to deposit liabilities? Second, does it give rise to assets of exceptional liquidity—convertible into cash at practically a moment's notice? With reference to the first question we find that neither banking law nor banking practice ever contemplates holding the resources representing surplus in the form of actual cash. Once the bank is a going concern, the ratio of cash to deposit liabilities (the legal reserve) remains quite unaffected by the creation of a surplus. This may be seen from the statistics of any growing bank over a period of years, and it may also be seen from a glance at the chart on page 1010 in this article. In fact, this chart shows that during a period when our national banks were accumulating large "surplus funds" the ratio of cash to deposits was steadily decreasing.

The answer to the second query is no less definite. The law makes no provision for investing resources arising from the creation of a surplus in assets of exceptional liquidity; in practice such assets are usually quite indistinguishable from any other assets. Clearly then, if the creation of a surplus is of importance, it can be in connection only with the problem of ultimate or liquidation solvency.

II

The relation of the surplus to ultimate liquidation is a more complicated problem, and its elucidation will require careful analysis. The practical argument in this connection is that since the accumulation of a surplus has increased the bank's assets the creditors will have a larger margin of security in the event of liquidation. That is, even though the resources representing the surplus account are in the form neither of actual cash nor of exceptionally liquid assets, they are nevertheless loaned in one way or another and therefore must eventually be paid in cash. An accurate analysis or test of this view can be made only by the use of sample balance sheets.

In order to save space and to avoid confusion, it will be advantageous to employ some greatly simplified statements of condition. Let us assume a bank with a capital of $100,000 that does not issue notes, and that does not have to spend a portion of the funds contributed by the shareholders in purchasing a building, furniture, and fixtures. All of its original resources will, therefore, be available for making loans. The initial statement (at the opening of business) would be as follows:

Assets		Liabilities	
Cash	$100,000	Capital stock	$100,000

As a going concern, assuming no deposits of actual specie, such a bank would shortly show (roughly speaking) the following condition of affairs:

Assets		Liabilities	
Cash	$100,000	Capital stock	$100,000
Loans	500,000	Deposits	480,000
		Interest and discounts collected	20,000

Before proceeding to an analysis of the surplus account we must pause here to explain the statement of condition before us.[1] To the novitiate the situation presented by these figures has three striking features: First, $500,000 of loans have been made, and

[1] The explanation here given contains nothing new, but it has seemed necessary to restate it in this paper in order that the reader who is unfamiliar with the general theory of commercial banking may be able to understand the argument which follows.

yet the $100,000 of cash originally on hand remains intact. Second, deposits have been created to the extent of $480,000, and the assumption was that no specie is brought to the bank. Third, loans and deposits have increased in nearly equal amounts; indeed, if it were not for the interest being deducted in advance they would have increased in precisely equal amounts.

In order to elucidate these phenomena we shall have to assume first a local community possessed of but a single bank. A goes to this bank for a loan of, say, $10,000. He does not withdraw the amount in cash but instead takes it as a deposit account ($10,000, ignoring for simplicity the discount) against which he may draw checks. This transaction therefore increases loans by $10,000 and deposits by a like amount. Immediately speaking, therefore, the loan has given rise to a deposit account, and we have a (superficial) explanation of the relation between loans and deposits and of the creation of deposit accounts without the actual deposit of specie. But this is only the beginning of the analysis. The borrower does not usually pay interest merely for the pleasure of having a checking account which he has no intention of using. In fact, he will withdraw most or all of his deposit account by writing checks against it. Let us assume that he writes a check for $10,000 payable to the order of B. B has the alternative of withdrawing actual cash or depositing the check with this bank as a deposit account. If he does the latter, the total of "deposits" remains as before: $10,000 has been deducted from A's account and placed to the account of B. Suppose, in turn, B writes two checks of $5000 each to C and D, respectively. C and D bring these checks to the bank and deposit them to their credit. The total of "deposits" remains as before; the names of the "depositors," merely, are different.

The bank under consideration makes additional loans to X, Y, Z, etc., totaling, say, $490,000. This gives rise, immediately speaking, to $490,000 of deposits (less the discount) in the names of X, Y, Z, etc. But X, Y, Z, etc., write checks against their accounts to E, F, G, etc., who deposit these checks to their credit and receive deposit accounts of $490,000. Thus, including the $10,000 loan to A, this bank now has $500,000 of loans and $500,-

000 of deposits, less the discount. The only questionable part of this illustration is the assumption that each of these individuals who receives a check deposits it with the bank for credit. In fact, not all do this; hence the necessity for a cash reserve. If all deposited checks for credit, no reserve whatever would be required.

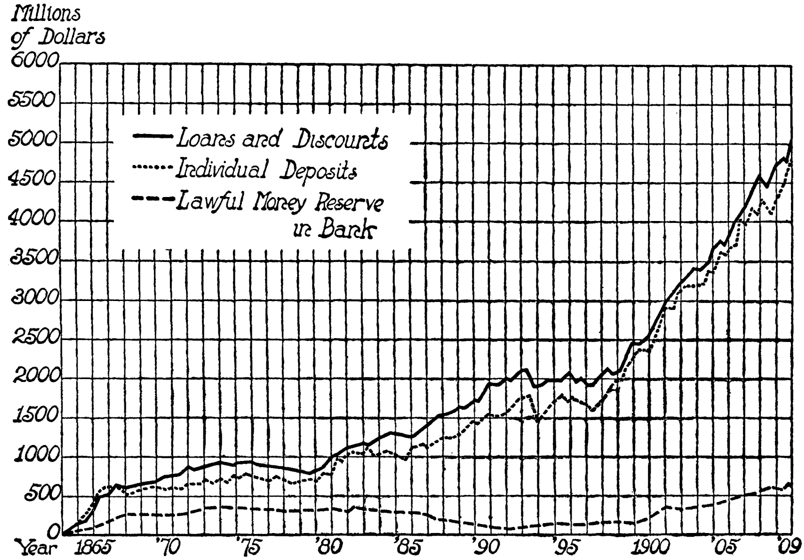
This situation is in no wise changed when we assume two or more banks in a given community instead of one. B (above) deposits his check with bank No. 2. Bank No. 2 presents this check to bank No. 1 for collection. But, since bank No. 2 has loaned $10,000 to F who deposits this in bank No. 1, bank No. 1 presents this claim against bank No. 2 as an offset against the $10,000 claim being presented by bank No. 2. The counterclaims balance and are cancelled. This is of course precisely what happens in our clearings for all the banks of a given community. For the banks as a whole in a given community, the creation of loans has given rise to a creation of deposits of roughly the same amount. Loans of bank A emerge and give rise to deposits partly in bank A, partly in bank B, bank C, etc. And loans of bank B, bank C, etc., emerge as deposits in one bank or another in this community. If the use of checks were universal and the machinery 100 per cent perfect, again, no payments would have to be made in cash, and no reserve would be required.[1] It is in fact, however, not a universal nor a perfect system.

But individuals do not confine their business activities to a single community. Some of these checks drawn on local banks are sent outside and are deposited in the banks of other communities. These are then sent home for collection. But as before, cash does not always need to be used in payment. We have district clearings. Counterclaims exist, also, and these are used as offsets, so that, as the saying goes, "Cash moves only as a last resort." At this point of course we come into contact with the machinery of domestic exchange. To make a long story short, the whole country constitutes a banking system, and in this system as a whole deposits

[1] Of course in a sense it is absurd to speak of a perfect system where no reserve would be required; for it would mean that loans and deposits might be indefinitely expanded. With all restraints thus removed the credit system would shortly blow up and burst.

largely grow out of loans and tend closely to parallel loans in amount.

We have been assuming given conditions. How far are such assumptions true in fact? The statistics of our banks as a whole bear out in a very remarkable manner the sort of relationship we have been suggesting. For instance, the statistics for all national banks show the following relations between loans, deposits, and lawful money reserve, from the formation of the national banking system to the year 1909.



The relationship that we have been discussing clearly holds true in surprising fashion for the national banks of the country, as a whole; it also holds surprisingly true for the banks of a given city; and this correlation is not greatly different even with individual banks, though there would obviously be considerable variation from time to time in the case of any single institution.

The variations from an exact equality of loans and deposits, which in fact occur, are due to: (*a*) some withdrawals of actual specie; (*b*) the occasional taking of a loan in the form of bank notes rather than as a checking account; (*c*) the creation of deposit accounts as a result of making advances in forms other than loans;

and (*d*) deposits of actual specie, which of course do not affect the loan item.

It will be observed from the chart before us that the loans and deposits created by the national banks are not merely five times the amount of the cash resources, as in our illustration above; they are some ten times the lawful money reserve. Were we to include state banks and trust companies this ratio of lawful money to deposits would appear still less.

It should be noted particularly that in the foregoing explanation we have been emphasizing the banking system as a whole. This emphasis is necessary, for it is only by a study of the whole rather than of the individual parts that one can obtain an adequate understanding of the principles of banking organization. It is because the practical banker is thinking in terms of his own single bank that he so rarely appreciates the true nature of these bank deposits. The banker thinks of his depositors as customers who bring funds to the bank. He is likely to argue that he loans out these deposits to borrowers. Loans would, therefore, appear to result from deposits rather than deposits from loans. A check for $10,000 deposited in bank A appears like a deposit of funds available for lending purposes. But the banker usually fails to recognize that the deposit account against which this check was drawn itself originally grew out of a loan by some bank somewhere.

We may now return to a consideration of the simplified balance sheet presented on page 1007. The ratio of cash to deposits in the statement given is 20.8 per cent. The ratio of assets to deposits, and hence the chance of ultimate liquidation, is $500,000 (loans) +$100,000 (cash)—a total of $600,000–$480,000 (deposits), or $60:48=5:4$.

The same bank in time accumulates a surplus of $20,000. Let us assume that the $20,000 represented by surplus is initially in the form of cash, having been accumulated from earnings[1]. On the

[1] Of course in actual practice the amount set aside as surplus is not represented specifically by a like amount of cash that is not utilized until semiannual dividend date. The process of investing "surplus funds" is a continuous one and not semiannual. For clearness of exposition, however, it is better to assume that surplus is represented by cash and that its investment follows rather than precedes the formal setting aside of such a fund.

basis of this new cash the bank now proceeds to expand its business by making additional loans. As a going concern it would then shortly present the following balance sheet.

Assets		Liabilities	
Cash	$120,000	Capital stock	$100,000
Loans	600,000	Surplus	20,000
		Deposits	576,000
		Interest and discount collected	24,000

The ratio of cash to deposits is still 20.8 per cent. The ratio of assets to deposits, and hence the chance of ultimate liquidation, is $600,000 (loans)+$120,000 (cash)—a total of $720,000—to $576,000 (deposits), or 720:576=5:4, the same as before the surplus was created. Resources have increased, it is true, but since deposit liabilities increased at the same rate the chances of the creditors being paid in full are no whit different from what they were without a surplus.

In fact, the depositors have a smaller chance of being paid in full than was the case before the surplus was created, for the reason that our banking laws provide that shareholders are doubly liable on capital stock, but not on account of surplus. When measuring the ultimate security of creditors this factor must be included. Correcting the foregoing ratios of assets to creditor liabilities by including the double liability of shareholders on capital stock we have, before the creation of a surplus, $500,000 loans+$100,000 (cash)+$100,000 (double liability on capital stock)=$700,000—to $480,000=35:24 or 1.458 to 1. In the second case it becomes $600,000 (loans)+$120,000 (cash)+$100,000 (double liability on capital stock)=$820,000—to $576,000=205:146, or 1.404 to 1—less than when there was no surplus account at all. It may be concluded therefore that rather than strengthening the position of the depositor the creation of a surplus really tends to weaken it.

In practice banks usually create surplus accounts far in excess of that required by law. The latest report of the comptroller shows the surplus of all national banks to be equal to seventy per cent of the capital stock; while in many banks it is much greater than the capital. The surplus and undivided profits accounts

together are almost exactly equal to capital stock, for national banks as a group. There appear to be various reasons for this setting aside of "surplus funds" rather than making additions to the capital account: The purchase of government bonds is required in proportion to capital, but not to surplus; the surplus is usually not taxed as is the capital; the creation of a surplus does not necessitate the issuing of additional shares of stock in conformity with legal requirements; and, finally, the owners of the bank are not doubly liable on surplus. It would be interesting to know to what extent this last consideration has been a potent reason for large surpluses.

III

Let us turn now to a consideration of Mr. Willis' statement of the purpose of creating a bank surplus, for it appears to set forth a somewhat different conception of the surplus than any we have been thus far considering.

> Had the bank possessed no surplus the capital would have been impaired to the extent of $15,000 [the amount stolen by the cashier][1] and the result would have been a necessary reorganization for the purpose of reducing the face value of its capital stock to an amount corresponding to the reduced net assets . . . . or else a call upon the stockholders to make good $15,000 in pro rata contributions in order to restore the capital to its face amount.

What Mr. Willis has in mind in this ambiguous statement[2] is doubtless the legal requirement in regard to a bank's capital. If the capital stock (par value) is $100,000 there must be at least $100,000 of assets, or the capital is legally impaired. If a bank starting with $100,000 capital stock should suffer an immediate loss of $15,000 of assets, it would legally be required to call for $15,000 additional cash from the shareholders or else reduce the capital stock to $85,000 by calling in some of the shares.[3] But if it has $20,000 surplus the total assets are still in excess of the capital stock, and therefore no reorganization is necessary. This,

[1] See quotation in full on p. 1004.

[2] My students have been unanimously confused by the statement, most of them getting the idea that the surplus is a sort of additional cash reserve.

[3] Willis does not mean "reducing the face value of its capital stock"; he means reducing the number of shares.

however, does not mean that the real assets have not been impaired, for it is merely a legal fiction that puts the surplus down as something other than capital. The strength of the bank has been lessened by $15,000 in either case. And it should be noted in passing that all this has no bearing whatever upon the security afforded the depositors; the real security is reduced as much in one case as in the other.

The creation of a surplus immediately upon starting a bank is sometimes regarded as important in affording a convenient accounting device whereby liabilities may be reduced proportionally with declining assets without tampering with the amount entered as *capital*.[1] This would obviously be important quite apart from the legal requirement discussed in the preceding paragraph. We have come generally to regard the capital account as inviolable, as standing for a permanent guaranty fund put up by the shareholders. Popular fear or distrust would therefore be aroused by a reduction of the capital account. The surplus may consequently be regarded as a useful accounting buffer whereby the net worth may be marked down without affecting the capital. This has an important psychological advantage; for, to many people, surplus marked down from $20,000 to $5,000 appears less serious than capital reduced from $100,000 to $85,000.

In the two preceding paragraphs we have been considering the advantages of an *initial* surplus in the banking business. It is, however, in connection with the surplus accumulated from earnings that the main problem exists. We find in practice that such a surplus possesses virtually no advantage as an accounting device, for banks have come to guard against a reduction of the surplus almost, if not quite, as jealously as against reducing the capital account. While the surplus can be reduced without reorganization, it is nevertheless such bad advertising to show a reduced surplus that its reduction is regarded as a last resort measure. The surplus, an increasing surplus, due to the belief that it represents both a profitable business and an increasing security for depositors, as

[1] We could of course write down the amount entered as capital, if losses were sustained, without any calling in of stock, if we should adopt in banking the policy of issuing stock without a par value.

already indicated, is one of the strongest advertising points that a bank can possess. To guard against an unfortunate "impairment of the surplus" banks usually carry a sort of secondary surplus account known as undivided profits.

It is this undivided profits item that most commonly serves as the accounting buffer. If there are losses in assets the undivided profits account is reduced instead of the surplus. Moreover, it is the common practice nowadays to carry very large undivided profits accounts, large enough to cover almost any loss without reducing the account to zero. The latest returns of the national banks to the comptroller show: capital, \$1,073,875,000; surplus, \$754,621,000; undivided profits, \$317,412,000.[1] That this is no new development may be seen from the figures for thirty years ago: capital, \$578,-462,765; surplus, \$173,913,440; undivided profits, \$71,451,167.[2] This undivided profits account is not, as many suppose, an account which disappears at each dividend date, a part going to shareholders as dividends, and the remainder to surplus. It is the profit and loss account that is thus periodically eliminated. The undivided profits account has come to serve as the buffer against the "impairment of surplus."

For the extraordinary losses with which banks occasionally meet, a writing down of the surplus may be avoided even though the bank does not possess an undivided profits account equal to the amount of the loss. The loss may be carried as a negative profit and loss account, though this has obvious disadvantages; it may be carried as *deficiency;* or it may be cared for by writing up assets that have been carried below market value. A few years ago the First National Bank of New York sustained losses, by defalcation, of \$690,000. Neither undivided profits nor surplus was reduced, the officers stating that the bank possessed a "secret reserve" sufficient to cover the loss. It appears that they wrote up the value of the real estate which had been carried at original cost—a figure substantially below the then actual market value.[3]

I mention these alternatives not as being better than an undivided profits account adequate to cover any losses that might

[1] Date of March 5, 1917. [2] Date of October 31, 1887.

[3] See Walton, *Advanced Accounting*, chap. xix.

in reason be incurred, but merely to show that the undivided profits item is not indispensable even as an accounting buffer.

It is interesting to note, also, that undivided profits has come quite generally to be regarded, like the surplus, as added security for the depositor. The two items are often entered together in bank statements as surplus and undivided profits. There is good advertising power in an undivided profits account as well as in a surplus; for the typical depositor regards it as additional net resources, if not, indeed, as cash in the vaults. It will be apparent without argument, however, that an undivided profits account does not increase the strength of the bank any more than does a surplus. The analysis here would obviously be identical with that already given for the surplus.

IV

If, then, the accumulation of "surplus funds" results in decreasing rather than increasing the security of the bank's creditors, should not something be done about it? Cannot a different use of these funds be required which will not result in a *pro tanto* increase of liabilities? Investment in bonds suggests itself as a possible alternative.

At first thought it would appear that an investment of $20,000 (representing surplus) in bonds would indeed increase the assets and add to the security of the depositor. Returning to the sample statement on page 1007 we should have:

Assets		Liabilities	
Cash	$100,000	Capital stock	$100,000
Bonds	20,000	Surplus	20,000
Loans	500,000	Deposits	480,000
		Interest and discounts collected	20,000

In this statement we have assumed that the purchase of $20,000 of bonds was made with actual cash. Now in such an event the ratio of assets to deposits would unquestionably be increased. But, in fact, would the purchase generally be made with specie? No; the corporation or individual that sells bonds to a bank would almost always take a checking account on this bank and check the amount out at pleasure, just as in the case of a loan secured by com-

mercial paper or collateral. It follows, of course, from this that the investment of a bank's surplus in bonds results in a proportional increase of deposits in this or other banks, and that the net result is the same as when these funds were used in the making of ordinary commercial loans. The ratio of assets to deposits is not altered, at least so far as the banking system as a whole is concerned.

If, rather than taking a checking account with the bank to which the bonds are sold, the seller receives payment by a draft on another bank, the situation as a whole is in no way changed. This bank merely reduces thereby its credits in some other bank and when the seller of the bonds places the draft to his credit in some bank this increases deposits for the system as a whole, just as before. In short, so long as credit instruments are the means of payment, deposit liabilities are increased somewhere in the banking system to an amount substantially equal to the increase of bonds on the assets side; and hence the surplus does not strengthen the position of depositors.

V

I should not like to be understood from the foregoing as arguing for the abolition of the practice of setting aside surplus and undivided profits. I do wish to be understood, however, as challenging the whole theory on which the legal requirement for and the practical accumulating of a surplus is based; and to urge that we no longer deceive ourselves with the notion that the surplus is an added protection to depositors.

From a quite different standpoint, however, the accumulation of a surplus by banks has possessed undoubted advantages. It has necessarily meant a constantly increasing size of banking institution. The requirement of the national banking law with reference to accumulating a surplus, coupled with the policy of the bank management in going far beyond the requirements of the law, has resulted in many cases in preventing the multiplication of small banks. A large number of small banks obviously means a great increase in the cost of conducting the banking business, owing to the great duplication of overhead expense; and it goes without saying that these extra costs must be passed on to the public in the form of higher rates.

Large banks also afford better protection to their creditors than small ones through the wider distribution of risks which they secure. The larger the number of borrowers and the more widely distributed the loans, the less the probability of heavy proportional losses. I am merely enunciating here the well-known principle of self-insurance. From this standpoint a bank may well argue that the growth of a surplus is some evidence of a sound institution.

In this connection it should be observed, however, that these advantages would all be secured quite as well by requiring constantly increasing capital as by requiring the accumulation of a surplus; and at the same time the double liability of shareholders on the additional capital would prevent the lessening of the ratio of total assets to total deposits. If we are to preserve the original ratio of assets to deposits with growing banks the growth must either be made through additional stock issues or else by requiring that the stockholders should assume a double liability on surplus as well as on capital stock.

It must be admitted also that the accumulation of a surplus from earnings over a period of years does usually indicate, as the banker contends, generally sound and successful management. It is only in the contention that the surplus, in itself, affords increased security to depositors that current bank advertising is misleading.

Finally, I should not like to be understood as being fearful of the solvency of our banks, or of arguing for legislation which would require banks to assume a double liability on account of surplus. Undoubtedly we can go on in the future without changing our legal requirements as to surplus and have no greater percentage of failures than we have had in the past. The character of the assets of the great mass of our banking institutions is clearly such as to give ample protection to bank depositors, even though the surplus affords no additional protection. The present discussion has, therefore, no practical purpose. "Truth for truth's sake" is its only justification.

HAROLD G. MOULTON

UNIVERSITY OF CHICAGO